

Report
of the
Examination of
NN Insurance Company
Brookfield, Wisconsin
As of December 31, 2000

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State of Wisconsin / OFFICE OF THE COMMISSIONER OF INSURANCE

Scott McCallum, Governor
Connie L. O'Connell, Commissioner

Wisconsin.gov

121 East Wilson Street • P.O. Box 7873
Madison, Wisconsin 53707-7873
Phone: (608) 266-3585 • Fax: (608) 266-9935
E-Mail: information@oci.state.wi.us
Web Address: oci.wi.gov

January 9, 2002

Honorable Alfred W. Gross
Chairman, Financial Condition (E)
Committee, NAIC
Commissioner of Insurance
Commonwealth of Virginia
Post Office Box 1157
Richmond, VA 23218

Honorable Donna Lee Williams
Secretary, Northeastern Zone I, NAIC
Insurance Commissioner
State of Delaware
Rodney Building
841 Silver Lake Blvd.
Dover, DE 19904

Honorable Sally McCarty
Secretary, Midwestern Zone III, NAIC
Commissioner of Insurance
State of Indiana
311 West Washington Street, Suite 300
Indianapolis, IN 46204-2787

Honorable Connie L. O'Connell
Commissioner of Insurance
State of Wisconsin
121 East Wilson Street
Madison, WI 53702

Commissioners:

In accordance with your instructions, a compliance examination has been made of the
affairs and financial condition of:

NN INSURANCE COMPANY
Brookfield, WI

and this report is respectfully submitted.

I. INTRODUCTION

The previous examination of the company was conducted in 1999 as of December 31, 1998. The current examination covered the intervening period ending December 31, 2000, and included a review of such 2001 transactions as deemed necessary to complete the examination.

The examination consisted of a review of all major phases of the company's operations, and included the following areas:

- History
- Management and Control
- Corporate Records
- Conflict of Interest
- Fidelity Bonds and Other Insurance
- Employees' Welfare and Pension Plans
- Territory and Plan of Operations
- Affiliated Companies
- Growth of Company
- Reinsurance
- Financial Statements
- Accounts and Records
- Data Processing

Emphasis was placed on the audit of those areas of the company's operations accorded a high priority by the examiner-in-charge when planning the examination. Special attention was given to the action taken by the company to satisfy the recommendations and comments made in the previous examination report.

The section of this report titled "Summary of Examination Results" contains comments and elaboration on those areas where adverse findings were noted or where unusual situations existed. Comment on the remaining areas of the company's operations is contained in the examination work papers.

The examination was conducted in cooperation with the Texas Department of Insurance examination of Highlands Insurance Company and its affiliates. Examiners from this office and the Texas Department coordinated their testing work on the company's two computer platforms and shared workpapers relating to such testing.

The company is annually audited by an independent public accounting firm as prescribed by s. Ins 50.05, Wis. Adm. Code. An integral part of this compliance examination was the review of the independent accountant's work papers. Based on the results of the review of these work papers, alternative or additional examination steps deemed necessary for the completion of this examination were performed. The examination work papers contain documentation with respect to the alternative or additional examination steps performed during the course of the examination.

Actuary's Review

The Texas Insurance Department actuaries conducted a review of the adequacy of the group's pooled loss and loss adjustment expense reserves. The results of their work were reported to the examiner-in-charge. As deemed appropriate, reference is made in this report to the actuaries' conclusion.

II. HISTORY AND PLAN OF OPERATION

NN Insurance Company (NNI) was organized in Wisconsin on June 22, 1987, as a stock property and casualty company. Its parent was and still is Northwestern National Casualty Company (NNCC). The companies' ultimate parent was originally Northwestern National Insurance Company of Milwaukee, Wisconsin. On December 1, 1989, a restructuring placed NNCC and its subsidiaries under the ownership of Northwestern National Holding Company, Inc. (NNHC), a Delaware Corporation. Vik Brothers Insurance Inc., an Indiana corporation, acquired NNHC on April 7, 1995. Highlands Insurance Group, Inc., a Delaware Corporation, became the controlling affiliate of the group on April 30, 1997, when it acquired Vik Brothers Insurance, Inc., and its subsidiaries.

The company is licensed in the following states:

Arizona	Kansas	Nebraska	South Dakota
Colorado	Kentucky	New Mexico	Texas
Delaware	Louisiana	North Carolina	Utah
District of Columbia	Maryland	North Dakota	Wisconsin
Georgia	Michigan	Ohio	Wyoming
Idaho	Mississippi	Oregon	
Indiana	Missouri	Pennsylvania	
Iowa	Montana	South Carolina	

The company writes direct premium in the states listed below. NNI cedes all premiums to its parent, NNCC.

	Direct Premium Written	% of Total
Pennsylvania	\$ 6,341,588	22.3%
Wisconsin	5,341,564	18.8
Iowa	5,100,899	17.9
Kansas	2,686,240	9.4
Montana	2,205,973	7.8
All others	<u>6,769,921</u>	<u>23.8</u>
Total	<u>\$28,446,185</u>	<u>100.0%</u>

The major products marketed by the company include workers' compensation, business owners, commercial auto, and personal auto. The major products are marketed through approximately 1,000 independent agents.

The following table is a summary of the net insurance premiums written by the company in 2000. As stated above, all business is ceded to NNCC. The growth of the company is discussed in the Financial Data section of this report.

Line of Business	Direct Premium	Reinsurance Assumed	Reinsurance Ceded	Net Premium
Fire	\$ 83,044	\$0	\$ 83,044	\$0
Allied lines	122,194	0	122,194	0
Farmowner's multiple peril	573,987	0	573,987	0
Commercial multiple peril	5,185,077	0	5,185,077	0
Inland marine	73,053	0	73,053	0
Earthquake	78	0	78	0
Worker's compensation	16,886,490	0	16,886,490	0
Other liability - occurrence	1,339,145	0	1,339,145	0
Other liability - claims made	32,295	0	32,295	0
Products liability - occurrence	84,735	0	84,735	0
Commercial auto liability	2,681,353	0	2,681,353	0
Auto physical damage	1,384,178	0	1,384,178	0
Burglary and theft	<u>556</u>	0	<u>556</u>	0
 Total All Lines	 <u>\$28,446,185</u>	 <u>\$0</u>	 <u>\$28,446,185</u>	 <u>\$0</u>

III. MANAGEMENT AND CONTROL

Board of Directors

The board of directors consists of five members who are elected annually by the sole shareholder. Officers are elected at the board's annual meeting. Members of the company's board of directors may also be members of other boards of directors in the holding company group. The board members currently receive no additional compensation for serving on the board.

As of July 1, 2001, the board of directors consisted of the following persons (updates are noted through December 31, 2001):

Name	Principal Occupation	Residence
Charles J. Bachand*	Sr. Vice President, Chief Financial Officer, Assistant Secretary, & Treasurer HIG	Skillman, NJ
Robert J. Brookes	Vice President, Assistant General Counsel & Assistant Secretary	Haddonfield, NJ
Stephen L. Kibblehouse	Sr. Vice President—Legal & Regulatory Compliance, Asst. General Counsel & Asst. Secretary, HIG	Doylestown, PA
Drew J. Magee	Sr. Vice President – Field Operations	Gillette, NJ
Georgean M. Wardzinski	Sr. Vice President—Human Resources & Administration, HIG	Moorestown, NJ

* - Charles J. Bachand resigned in November 2001 and was replaced by the following individual:

Name	Principal Occupation	Residence
Albert J. Marino	Chief Financial Officer, & Treasurer	Princeton, NJ

Officers of the Company

The officers elected by the board of directors and serving at July 1, 2001 are as follows (updates are noted through December 31, 2001):

Name	Office	2000 Compensation
Willis T. King, Jr.*	Chairman & CEO	\$665,231
John W. Cowley	President & COO	398,718
Charles J. Bachand*	Sr. Vice President, CFO, Asst. Secretary, & Treasurer	269,252
David C. Donaldson	Sr. Vice President – Claims	206,812
Stephen L. Kibblehouse	Sr. Vice President, General Counsel, & Secretary	206,207
Drew J. Magee	Sr. Vice President – Field Operations	168,452
Robert E. Masterson (Replaced Robert C. Resch during 2001)	Sr. Vice President – Information Technology	182,188@
Georgian M. Wardzinski	Sr. Vice President – Human Resources, & Administration	165,000
Edward R. Lang, II (Replaced previously vacant position during 2001)	Sr. Vice President, & Chief Underwriting Officer	372,632@
Robert J. Brookes	Vice President, Asst. General Counsel, & Asst. Secretary	12,019
Michael J. Fanale	Vice President – Casualty Claims	161,044
Houston D. Hemp	Vice President – Property Claims	130,798
Pamela J. Olson	Vice President – Commercial Underwriting	129,128
Richard C. Plunkett	Vice President, & Chief Actuary	176,186
Laurie A. Ranegar	Vice President – Claim Field Operations	114,966
Armando Romeo*	Vice President – Field Support Underwriting	134,190
Ronald A. Stuepfert*	Vice President – Investments	160,812
Susan M. Taylor	Vice President – Personal Lines	115,346
David Vernon White	Vice President – Major Accounts	175,421

All officers are compensated by Highlands Insurance Group, Inc.

@ Newly elected in 2001. Amount represents projected 2001 compensation.

* - Willis T. King, Jr., Charles J Bachand, Ronald A. Stuepfert and Armando Romeo all resigned either at the end of 2000 or during 2001.

IV. AFFILIATED COMPANIES

NNI is a member of a holding company system. The organizational chart below depicts the relationships among the affiliates in the group. A brief description of the significant affiliates of NNI follows the organizational chart.

Organizational Chart As of December 31, 2000

- Highlands Insurance Group, Inc. (DE)
 - American Reliance, Inc. (IN)
 - Northwestern National Holding Company, Inc. (DE)
 - Northwestern National Casualty Company (WI)
 - NN Insurance Company (WI)**
 - State Capital Insurance Company (NC)
 - American Professionals Insurance Company (IN)
 - Certified Finance Corporation (TX)
 - Insurance Management Corporation (TX)
 - SICO, Inc. (IN)
 - Statesman Insurance Company (IN)
 - Timeco, Inc. (IN)
 - Pacific National Insurance Company (CA)
 - Pacific Automobile Insurance Company (CA)
 - Highlands Holding Co., Inc.
 - Highlands Insurance Company
 - Highlands Underwriters Insurance Company
 - Highlands Casualty Company
 - Aberdeen Insurance Company
 - Underwriters Special Risks, Inc.
 - Highlands Lloyds
 - Highlands Claims and Safety Services
 - Highlands Holdings (UK) Ltd.
 - Highlands Insurance Company (UK) Ltd.
 - Highlands Underwriting Agents Ltd.
 - Highlands Ltd.
 - Highlands Overseas Limited
 - Highlands Services Corp.

Highlands Insurance Group, Inc. (HIG)

HIG is an insurance holding company and the ultimate parent of NNCC. Until January 23, 1996, HIG was owned by Halliburton Company. On that date, the shares of HIG's common stock were distributed to Halliburton's stockholders in the form of a dividend. HIG is publicly traded on the New York Stock Exchange under the symbol "HIC".

As of December 31, 2000, HIG's audited consolidated financial statements reported assets of \$1.2 billion, liabilities of \$1 billion, and total stockholders' equity of \$203 million on a GAAP basis. Operations for 2000 produced a net loss of \$45 million.

Northwestern National Casualty Company

NNCC is a Wisconsin-domiciled property and casualty insurer and the direct parent of NNI. NNCC writes workers compensation, commercial multiple peril, and other commercial and personal lines of business, and assumes 100% of the business written by NNI and two other subsidiaries. NNI was examined concurrently with NNCC. As of December 31, 2000, NNCC's audited annual statement reported admitted assets of \$263,484,068, liabilities of \$213,634,664, and capital and surplus of \$49,849,404. Operating results for 2000 produced a net loss of \$26,321,829.

Affiliated Agreements

Most of the companies in the group, including NNI, have entered into a Group Services Agreement, which provides for the reimbursement of expenses incurred by one company in the group for the benefit of an affiliate.

V. REINSURANCE

The company cedes all of its business to NNCC under the agreement outlined below. The contract contained proper insolvency provisions.

1. Type: Quota Share
 Reinsurer: NNCC
 Scope: All policies issued by NNI
 Retention: None
 Coverage: 100% of the losses and expenses incurred by NNI
 Premium: 100% of the premiums collected on the policies reinsured
 Effective date: September 1, 1987
 Termination: By agreement of the parties as of the end of any calendar
 quarter

VI. FINANCIAL DATA

The following financial statements reflect the financial condition of the company as reported in the December 31, 2000, annual statement to the Commissioner of Insurance. Also included in this section are schedules which reflect the growth of the company, NAIC Insurance Regulatory Information System (IRIS) ratio results for the period under examination, and the compulsory and security surplus calculation. Adjustments made as a result of the examination are noted at the end of this section in the area captioned "Reconciliation of Members' Surplus per Examination."

**NN Insurance Company
Assets
As of December 31, 2000**

	Ledger Assets	Nonledger Assets	Nonadmitted Assets	Admitted Assets
Bonds	\$7,054,874	\$	\$	\$7,054,874
Cash	(5,225)			(5,225)
Short-term investments	742,780			742,780
Receivable for securities	10,234			10,234
Interest, dividends, and real estate income due and accrued	<u> </u>	<u>145,468</u>	<u> </u>	<u>145,468</u>
Total Assets	<u>\$7,802,663</u>	<u>\$ 145,468</u>	<u>\$</u>	<u>\$7,948,131</u>

**NN Insurance Company
Liabilities, Surplus, and Other Funds
As of December 31, 2000**

Federal and foreign income taxes (excluding deferred taxes)	\$ 43,496
Payable to parent, subsidiaries, and affiliates	<u>3,816</u>
Total Liabilities	47,312
Common capital stock	2,500,000
Gross paid in and contributed surplus	3,761,478
Unassigned funds (surplus)	<u>1,639,341</u>
Surplus as Regards Policyholders	<u>7,900,819</u>
Total Liabilities, Surplus, and Other Funds	<u>\$7,948,131</u>

**NN Insurance Company
Summary of Operations
For the Year 2000**

Investment Income

Net investment income earned	\$ 506,687
Net investment gain or loss	<u>506,687</u>

Other Income

Net income before dividends to policyholders and before federal and foreign income taxes	506,687
Net income after dividends to policyholders but before federal and foreign income taxes	506,687
Federal and foreign income taxes incurred	<u>176,305</u>
Net Income	<u>\$ 330,382</u>

**NN Insurance Company
Cash Flow
As of December 31, 2000**

Investment income (net of investment expense)	\$526,454	
Federal income taxes paid (recovered)	<u>238,870</u>	
Net cash from operations		\$287,584
Proceeds from investments sold, matured, or repaid:		
Bonds	605,000	
Miscellaneous proceeds	<u>3,231</u>	
Total investment proceeds	<u>608,231</u>	
Net cash from investments		608,231
Cash provided from financing and miscellaneous sources:		
Borrowed funds received	<u>2,479</u>	
Total	2,479	
Cash applied for financing and miscellaneous uses:		
Dividends to stockholders paid	<u>250,000</u>	
Total	<u>250,000</u>	
Net cash from financing and miscellaneous sources		<u>(247,521)</u>
Net change in cash and short-term investments		648,294
Reconciliation		
Cash and short-term investments, December 31, 1999		<u>89,263</u>
Cash and short-term investments, December 31, 2000		<u>\$ 737,557</u>

NN Insurance Company
Compulsory and Security Surplus Calculation
December 31, 2000

Assets		\$7,948,131	
Less liabilities		<u>47,312</u>	
Adjusted surplus			\$7,900,819
Annual premium:			
Individual accident and health	\$0		
Factor	<u>15%</u>		
Total		0	
Group accident and health	0		
Factor	<u>10%</u>		
Total		0	
All other insurance	0		
Factor	<u>20%</u>		
Total		<u>0</u>	
Compulsory surplus (subject to a minimum of \$2 million)			<u>2,000,000</u>
Compulsory surplus excess (or deficit)			<u>\$ 5,900,819</u>
Adjusted surplus			\$7,900,819
Security surplus:			
(140% of compulsory surplus, factor reduced 1% for each \$33 million in premium written in excess of \$10 million with a minimum of 110%)			<u>2,800,000</u>
Security surplus excess (or deficit)			<u>\$ 5,100,819</u>

**NN Insurance Company
Reconciliation and Analysis of Surplus
For the Three-Year Period Ending December 31, 2000**

The following schedule is a reconciliation of total surplus during the period under examination as reported by the company in its filed annual statements:

	1998	1999	2000
Surplus, beginning of year	\$8,511,708	\$5,807,473	\$7,820,435
Net income	295,765	251,480	330,382
Surplus changes:			
Paid-in		1,761,482	
Dividends to stockholders	(3,000,000)		(250,000)
Surplus, end of year	<u>\$5,807,473</u>	<u>\$7,820,435</u>	<u>\$7,900,817</u>

**NN Insurance Company
Insurance Regulatory Information System
For the Five-Year Period Ending December 31, 2000**

The following is a summary of NAIC Insurance Regulatory Information System (IRIS) results for the period under examination. Exceptional ratios are denoted with asterisks. A discussion of the exceptional ratios may be found after the IRIS ratios.

	Ratio	1996	1997	1998	1999	2000
#1	Gross Premium to Surplus	366%	336%	379%	284%	360%
#1A	Net Premium to Surplus	0	0	0	0	0
#2	Change in Net Writings	0	0	0	0	0
#3	Surplus Aid to Surplus	0	0	0	0	0
#4	Two-Year Overall Operating Ratio	0	0	0	0	0
#5	Investment Yield	5.4	6.4	6	6.1	6.6
#6	Change in Surplus	3	4	-32*	35	1
#7	Liabilities to Liquid Assets	2	1	1	1	1
#8	Agents' Balances to Surplus	0	0	0	0	0
#9	One-Year Reserve Devel. to Surplus	0	0	0	0	0
#10	Two-Year Reserve Devel. to Surplus	0	0	0	0	0
#11	Estimated Current Reserve Def. To Surplus	0	0	0	0	0

As mentioned previously, NNI cedes all of its business to NNCC and as a result many of the IRIS ratios are zero. IRIS ratio number 5 is exceptional in 1998 and is due to a \$3,000,000 dividend paid to NNCC during the year.

Growth of NN Insurance Company

Year	Admitted Assets	Liabilities	Surplus As Regards Policyholders	Net Income
1998	\$5,849,542	\$42,069	\$5,807,473	\$295,765
1999	7,927,832	107,398	7,820,434	251,480
2000	7,948,131	47,312	7,900,819	330,382

Year	Gross Premium Written	Net Premium Written	Premium Earned
1998	\$22,016,178	\$	\$
1999	\$22,196,809	\$	\$
2000	\$28,446,185	\$	\$

As mentioned previously, NNI cedes all of its business to NNCC. The increase in surplus during 1999 was mainly due to surplus paid-in of \$1,761,482. The increase in Gross Premium Written was reflective of the Highlands Insurance Group's (HIG) efforts to pursue perceived market opportunities. See the section of the report titled "Subsequent Events" as the future group's writings as well as NNI's writings will be reduced significantly as a result of revised business plans.

Reconciliation of Surplus per Examination

No adjustments were made to surplus as a result of this examination.

VII. SUMMARY OF EXAMINATION RESULTS

Summary of Current Examination Results

As mentioned previously, NNI cedes all of its business to NNCC. This results in the company being both financially and operationally dependent on its direct parent. NNCC is a 30% participant in the Highlands Insurance Group Pool. This creates an indirect dependency by NNI that extends to the Highland Insurance Group (HIG).

In recent years, weak operating results have been generated by the group, which were primarily attributed to its high expense structure combined with adverse loss reserve development. NNCC's operating results have mirrored the group's poor results and are demonstrated by the company's reported surplus decreasing by over \$30 million during 1999 and 2000.

Due to the company retaining no net risk associated with its writings, NNI's surplus has not been affected by the results of other affiliated companies. However, during 2001, NNCC and the other members of the HIG group continued to report significant adverse development and subsequently adjusted the group's business plans. For changes to HIG's business plans see the section of the report titled "Subsequent Events".

There were no recommendations as a result of the previous examination and no specific recommendations were made during the current examination. However, 18 recommendations were made as a result of the examination of NNCC, which indirectly affected NNI.

VIII. CONCLUSION

Direct premiums increased during the period under examination. All premiums are ceded 100% to NNI's parent, NNCC. Surplus increased by \$3,906,656 during the period under examination. The increase was related to surplus paid-in of \$1,761,482 during 1999 and investment income during the exam period.

The examination found that NNI's financial statement was fairly stated and made no adjustments or reclassifications. No recommendations were made as a result of the current examination. However, eighteen recommendations were made in the examination report of NNCC, which indirectly affect NNI.

As result of the current examination, NNI's admitted assets, liabilities, and capital and surplus were as follows

Admitted assets	\$7,948,131
Liabilities	<u>47,312</u>
Capital and surplus	<u>\$7,900,819</u>

IX. SUMMARY OF COMMENTS AND RECOMMENDATIONS

There were no recommendations as a result of the examination. However, eighteen recommendations were made as a result of the examination of NNCC, which indirectly affect NNI.

X. ACKNOWLEDGMENT

The courtesy and cooperation extended during the course of the examination by the officers and employees of the company are acknowledged.

In addition to the undersigned, the following representatives of the Office of the Commissioner of Insurance, State of Wisconsin, participated in the examination:

Name	Title
Cruz Flores	Data Processing Audit Specialist
Jerry C. DeArmond	Policy and Claim Reserve Specialist
Kerri Miller	Insurance Financial Examiner
Christine Shan	Insurance Financial Examiner
Sonja Dedrick	Insurance Financial Examiner

Respectfully submitted,

Tim Vande Hey
Examiner-in-Charge
Insurance Financial Examiner

XI. APPENDIX—SUBSEQUENT EVENTS

December 7, 2001, Highlands Insurance Group, Inc., the ultimate parent of NNI, announced that the Board approved a plan pursuant to which the Company will cease, as soon as practical and as permitted by applicable insurance law, issuing any new or renewal insurance policies. Pursuant to the plan, the Company is considering selling books of business or transferring renewal rights to third parties. The Company also hired investment advisors during 2001 that continue to search for strategic alternatives and plans to continue reducing staffing levels and expenses as appropriate. In addition, Highlands group named Stephen Kibblehouse its sole Chief Executive Officer and Albert Marino was named Chief Financial Officer and Treasurer.

December 11, 2001, the New York Stock Exchange suspended trading in the common stock of Highlands Group.